Non-Executive Report of the: **Pensions Committee** 13 March 2019	TOWER HAMLETS
Report of: Neville Murton, Corporate Director, Resources	**Classification:** Unrestricted
Independent Advisor Report on Market Outlook and Investment Managers Performance for Quarter Ending 31 December 2018	

Originating Officer(s)	Bola Tobun, Investment & Treasury Manager
Wards affected	All wards

Summary

This report presents the views of the Independent Adviser (Colin Robertson) in respect of the performance of the markets and the Pension Fund investment managers for the third quarter of 2018/19.

The Independent Adviser will also be present at the meeting to take questions from Members.

Recommendations:

Members are recommended to note the contents of this report

1. REASONS FOR THE DECISIONS

1.1. The report presents the Pensions Committee with the views of the Fund's Independent Adviser on markets and the performance of the Fund pension fund managers and the overall performance of the Tower Hamlets Pension Fund. This is intended to assist Members with their considerations on relevant issues.

1.2. The governance role of the Pensions Committee requires that they ensure that they take proper advice at reasonable intervals about its investments and must consider such advice when taking any steps in relation to its investments.

1.3. Understanding and being aware of the financial markets and its economics dynamics will assist the Committee in considering the longer term financial impact of its strategy for the Pension Fund and the investment decisions it makes as a consequence.

2. ALTERNATIVE OPTIONS

2.1. The Pension Fund Regulations require that the Council establishes arrangements for monitoring the investments of the Pension Fund and to engage the use of an expert in gaining required knowledge and advice. .

2.2. The Fund employs professional investment advisors to undertake that role (Mercers) but also uses an independent advisor to provide challenge and support on the advice and direction of the fund on investment and other relevant matters. It could adopt alternative arrangements provided that it satisfies itself that this was reasonable in the circumstances.

3. MARKETS AND ECONOMICS UPDATE (Quarter to 31 December 2018) FROM THE INDEPENDENT ADVISER TO THE FUND – Colin Robertson

Market performance

3.1 Equity markets fell very sharply over the 3 months to 31 December 2018. In contrast to the first 9 months of the year, the US was among the weakest markets and Emerging Markets among the strongest. Numerous reasons can be provided for the falls, both political (trade wars, US government shutdown, Brexit and populist policies) and economic (fears over health of Chinese economy, over economic slowdown elsewhere and over the US Federal Reserve Board raising interest rates too quickly).

3.2 At the time of writing, this year equity markets have regained about half of the losses experienced in Q4 2018. This continues the erratic trend of 2018 when markets fell in Q1 before rising until Q4 when they collapsed. After 10 years of economic expansion and rising stock markets, it is perhaps not surprising that equity markets should have a setback and become more volatile.

3.3 Government bond yields fell sharply (prices rose) over the quarter, as government bonds acted both as a safe haven from equity markets and reflected fears over economic growth. This latter factor also led credit spreads (excess yields of corporate bonds over government bonds) to rise, leading to falls in corporate bond prices.

Economics and markets

3.4 Economic growth is stuttering in the UK and Europe, slowing in the US, modest in Japan and questionable in China. Meanwhile policymakers pose a threat. Will the Brexit shambles lead to a UK recession as companies hold off investing or even withdraw? Will Trump raise tariffs on Chinese goods from 10% to 25% on March 1 as stated? Will Japanese policymakers provide sufficient stimulus to offset the planned increase in the consumption tax rate in September?

3.5 For the time being, investors are once more placing their faith in central banks. The US Federal Reserve Board’s pause in raising interest rates and indications from other central banks that cuts as well as rises in interest rates are possible have calmed investors. Higher wage inflation set against stable consumer price inflation is increasing consumer spending power and therefore potentially boosting consumption. Importantly, some of the potential negative developments suggested above may not come to pass, resulting in an increase in consumer and business confidence.

3.6 Nevertheless, the economic outlook is highly uncertain. Thankfully, the prospects for financial markets such as equities depend on factors other than economic growth and some of these other factors are more encouraging.

3.7 Improving corporate governance is highly topical, often from the perspective of the longer term issues of diversity, climate change and sustainability more generally. However, improvements in corporate governance can also have a positive impact in the shorter to medium term. Examples would be a better alignment of remuneration with shareholder objectives, better allocation of capital, independent directors and unwinding of cross shareholdings. Such improvements are taking place, notably in Emerging Markets and Japan, but also in developed Western markets.

3.8 Equity markets are not particularly expensive after the falls in share prices and the decent growth in corporate earnings which we have seen. Admittedly, earnings forecasts for 2019 have been lowered but mid-single digit growth in earnings is still anticipated. Of course, a recession would lead to cuts in earnings forecasts but dividend yields well in excess of bond yields should provide some sort of support.

3.9 Government bond yields have continued to fall during 2019 and are now at extremely low levels historically. UK index linked gilts offer a yield of around negative 2%, which one pundit has described as “return free risk”, the opposite of the more common claim to “risk free return”. Even fixed income gilts offer negative returns after allowing for expected future inflation. A recession or flight to safety from an equity market crash could push yields still lower but it is difficult to envisage significantly lower yields being sustained over the medium term.

Asset allocation

3.10 Given my comments above with regard to the outlook for equity markets, the equity protection strategy which has been put in place to partly hedge the fund’s very sizeable underlying equity exposure continues to look justified.

3.11 From a long term strategic perspective, it would be reasonable for the fund to have a greater exposure to longer dated gilts and / or corporate bonds so as to provide a partial hedge against adverse movements in the value of the liabilities. However, given the current extremely low level of gilt yields and uncertain outlook for corporate spreads, this would not appear to be an ideal time to put such a strategy in place.

3.12 The fund has a number of holdings in bond products of a “cash plus” nature. Unfortunately, the two “absolute return bond” continue to lose money, never mind achieve their target returns (see below) and a reappraisal of the fund’s specific investments of this nature may be in order. In particular these investments might be considered a suitable source of cash to finance the fund’s potential investment in infrastructure.

Investment Managers Performance Review

Active Equity Fund

3.13 The LCIV Baillie Gifford Global Equity fund underperformed its benchmark again in the latest quarter, this time by 1.8% after underperformance of 2.6% in the previous quarter. While this should not be taken lightly, it does follow a prolonged period of significant outperformance and the manager appears to be sticking to their investment philosophy. Consequently, this can be considered a situation to monitor rather than one requiring immediate action.

3.14 The fund has benefitted in recent years from its holdings in very high growth tech related stocks such as Amazon, Alphabet (which owns Google) and Alibaba in China. However in the quarter under review this type of stock performed especially badly, notably the holdings in Amazon and Grubhub (a food delivery company). Also, the price of Brent oil fell 35% over the quarter and two energy company holdings, Apache and EOG, performed badly. More positively, a feature of the fund is its continuing above average exposure to Emerging Markets (EM) equities and on this occasion this boosted performance, both through the high level of overall EM exposure and in particular through individual stock selection in India and Brazil

Diversified Growth Funds

3.15 The LCIV Baillie Gifford and LCIV Ruffer funds are held to produce attractive returns over the medium to longer term while providing diversification away from equities. However both funds do have some sensitivity to equity market movements and from time to time the managers take action to protect the fund from falling equity markets. More specifically, Baillie Gifford held VIX futures which they sold during the quarter while Ruffer held CDS instruments, options, gold and a sizeable holding in bonds.

3.16 Unfortunately, these actions were not effective in any meaningful way during the quarter with both funds falling by around 5%. This was a much better performance than equity markets but not what would expect from funds whose stated target is to beat cash, be it over the medium term. The causes appear to have been too little protection, hedging away the interest rate component of the index-linked holdings which would have otherwise provided protection (Ruffer) and holding other badly performing assets, notably in particular property and insurance linked bonds (Baillie Gifford).

Absolute Return Bond Funds

3.17 Bond fund managers had to contend with two opposing factors during the 3 month period: government bond yields fell and prices rose while credit spreads (excess yields of corporate bonds over government bonds) rose, leading to falls in corporate bond prices. This led to opportunities as well as risks. Sadly, Insight and GSAM did not cope well with this backdrop and their funds fell by 1.3% and 0.7% respectively over the quarter. Combined with previous quarters' underperformance, this led to the managers falling short of their target returns in 2018 by a remarkable 7.7% and 7.3% respectively. Remember, unlike equity funds, absolute return bond funds aim to preserve capital.

3.18 Digging into the details, Insight got their country selection right this quarter but managed to be wrong in 7 of the other 8 components of performance as they analyse it. GSAM also benefitted from their country selection as well as their currency strategy but got the direction of both government bond yields and credit spreads wrong. 3.16 The Schroder Real Estate Capital Partners fund beat its benchmark by 0.2% over the quarter and outperformed by 1.1% over the last 12 months. This can be considered good for a fund which invests in other funds (as distinct from investing directly), therefore bearing a double layer of costs, and especially when 20% of the portfolio was repositioned during the year. The holding in the Aviva Pensions Investors fund was sold during the year, partly to avoid being exposed to the costs of the new manager of the fund reorganising the portfolio. An investment strategy of underweighting Central London offices relative to the benchmark and emphasising industrial, specialist and more defensive property with an income bias remains unchanged.

Multi Asset Credit Fund

3.19 The LCIV CQS Multi Asset Credit Fund also underperformed in Q4 2018 with the fund falling by 1.9%. The manager claims that they were affected by material dislocations in market pricing rather than by credit market fundamentals. However it is worth noting that they underperformed in all 5 sub asset classes, as well as in their currency strategy. In their favour they have had a strong performance until this latest quarter (taking into account periods prior to the launch of the LCIV fund) and they are forced to invest in credit unlike the absolute return bond fund managers. Part of the underperformance can possibly be attributed to the cost of taking new positions on board.

Property Fund

3.20 The Schroder Real Estate Capital Partners fund continued its solid performance, being broadly in line with its benchmark last quarter and outperforming by 0.3% p.a. over one year and by 0.4% p.a. over 3 years. Once again, European property was a drag on performance. There is no change in their strategy of overweighting the strongly performing industrial sector and favouring regional offices over Central London offices. Potential investment in retirement villages and assisted living would make the portfolio less cyclical.

Passive Funds

3.21 The LGIM passive funds performed in line with their benchmarks as one would expect.

4. COMMENTS OF THE CHIEF FINANCE OFFICER

4.1. This report has been produced independently by Colin Robertson to inform the Committee's knowledge and understanding of a wide range of issues relating to the Pension Funds investment activiity. There are no other direct financial implications arising from this report.

5. LEGAL COMMENTS

5.1. In accordance with the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016, the Council must take proper advice about its investments and must consider such advice when taking any steps in relation to its investments. Where the Council appoints an investment manager, it must keep the manager's performance under review. At least once every three months the Council must review the investments that the manager has made and, periodically, the Council must consider whether or not to retain that manager. One of the functions of the Pensions Committee is to meet the Council's duties in respect of investment matters. It is appropriate, having regard to these matters, for the Committee to receive information about the performance of the markets and the performance of appointed investment managers. The Committee's consideration of the information in the report contributes towards the achievement of the Council's statutory duties.

5.2 When reviewing the Pension Fund Investment Performance, the Council must have due regard to the need to eliminate unlawful conduct under the Equality Act 2010, the need to advance equality of opportunity and the need to foster good relations between persons who share a protected characteristic and those who don't (the public sector duty). The Committee may take the view that good, sound investment of the Pension Fund monies will support compliance with the Council's statutory duties in respect of proper management of the Pension Fund.

6. ONE TOWER HAMLETS CONSIDERATIONS

6.1. The employer's contribution is a significant element of the Council's budget and consequently any improvement in investment performance will reduce the contribution and increase the funds available for other corporate priorities.

6.2. A viable pension scheme also represents an asset for the recruitment and retention of staff to deliver services to the residents.

7. BEST VALUE (BV) IMPLICATIONS

7.1. This report helps in addressing value for money through benchmarking the Council's performance against the WM Local Authority Universe of Funds.

8. SUSTAINABLE ACTION FOR A GREENER ENVIRONMENT

8.1. There is no Sustainable Action for A Greener Environment implication arising from this report.

9. RISK MANAGEMENT IMPLICATIONS

9.1. Any form of investment inevitably involves a degree of risk.

9.2. To minimise risk the Council attempts to achieve a diversification portfolio. Diversification relates to asset classes and management styles.

10. CRIME AND DISORDER REDUCTION IMPLICATIONS

10.1. There are no crime and disorder reduction implications arising from this report.

Linked Reports, Appendices and Background Documents

Linked Report
- [None]

Appendices
- [None]

Local Government Act, 1972 Section 100D (As amended)
List of "Background Papers" used in the preparation of this report
- [None]

Officer contact details for documents:
- Bola Tobun Investment &Treasury Manager x4733